TAX BULLETIN

SUCCESSION PLANNING FOR THE TRANSITION OF THE FAMILY FARM

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Changing demographics predict that three of every four businesses will change hands in the next ten years when the majority of Canada's producers, processers and other family business owners retire. Yet studies show that only 25% of these business owners have a concrete succession plan in place — the vast majority have no plan to transition the business to the next generation and no plan to sell to an outside party.

It is a fact that every business owner will exit one day — either voluntarily as a result of a planned lifestyle change, or involuntarily due to death, disability, disagreement or decline. With so few business owners preparing ahead for a voluntary exit from the farm operation, the future of many farm communities is at risk. From coast to coast, the successor generation is facing extreme odds. Historically, only one-third of North American business owners successfully pass the baton to the next generation and this number is expected to decline even further as baby boomers fail to plan.

Canadian farms and agribusinesses need to be more proactive in developing an integrated transition plan to address the roadblocks that are known to contribute to a failed transition. They need to follow a process that will ensure the current owners can exit under their terms - with the choice to either sell internally to a family member or farm manager, or externally to a third party. At the same time, they need to take steps to protect their families and their operations from an involuntary sale.

This bulletin will outline the three differing groups of assets that are essential to the continuity of the Canadian farm or agribusiness following a transition of ownership and leadership. It will then drill down into the protection and preservation of the physical capital that is key to the future lifestyle of the exiting and successor generations — and the sustainability of the operation itself.

General comments about family farm businesses

As an owner of a farming business, chances are you've worked hard to build your business and you want your business to continue to thrive after you retire, whether your children succeed you or you sell your business to others. As well, chances are that your farm is your biggest asset, so doing all you can to maximize the value of it when you do exit from it is vitally important to your financial future.

Planning to ensure your family business' success

As a family farm owner you are probably quite busy. Indeed, at times you may feel there are barely enough hours in the day to keep up with the day-to-day pressures of family and business, and long-term planning can seem like a luxury you just don't have time for. But, as an experienced businessperson, you also know that without proper planning, businesses (and families) don't flourish.

This bulletin is intended to help you start thinking more about a number of issues you should consider to plan for your financial future and for your business' future. The first half of this bulletin focuses mainly on succession planning for your business, as well as some business planning strategies you should consider. The second half of this bulletin focuses on retirement planning in general, estate planning and the need to coordinate these plans with your succession plan.

As you go through this bulletin with a view toward creating your own succession plan and estate plan, remember that your BDO advisor is ready to help you at every stage.

Why families don't retain their businesses

As noted earlier, a surprisingly small number of family-owned businesses survive transition to the second generation (although we believe the statistics may be better for family farms). There are two common reasons why families don't retain their businesses. The first reason is straightforward: there is no qualified successor. However, even if your business will not be passed down to the next generation, making sure you take steps to ensure the value of your business survives is just as important and is really just another form of succession planning.

The second major reason for unsuccessful business transitions is more unfortunate. In many cases, family businesses fail or are sold off because of a lack of planning. Though most of us are careful to safeguard our personal assets, for example, insuring our homes, many businesspeople do not plan ahead to safeguard the value of their business.

At first glance, this lack of planning seems incomprehensible. But, when you look at the personal and family issues involved, it is easy to understand why many people just don't want to deal with the issue of business succession.

For business owners in general, their business is their single largest asset in terms of value. And in general, this issue is even more acute for family farm owners. But, beyond that, their business also represents a major source of self-esteem and personal worth. In short — for many business owners, their identity is very much wrapped up in their business. So, thinking about how they might exit the business means they must come to grips with personal identity issues. Consequently, many just don't want to think about the day when they retire and are no longer running the business.

In addition to the fear of retirement, the business succession process must invariably deal with the business owner's death. Surveys showing how few of us have prepared a will are clear evidence that death is difficult for most to contemplate.

Finally, for those individuals making it past the first two succession planning hurdles (contemplating retirement and death), there is one more tough issue that is easy to put off: picking one child as your successor while ensuring you are being fair to all your children. This decision is that much tougher for family farm owners given that the family home is often transferred to the child that will run the farm and it may mean that both you and your other children will have to leave the farm as part of the succession plan. In addition, the farm may only support one family.

All of these issues are difficult to deal with. Because it takes time to thoughtfully address these issues, planning for your succession is — by necessity — a process rather than an event. Also, given that most of the major decisions to be made are of a personal nature, the process used to manage each family's business succession will vary greatly depending on the nature of the family issues involved. Consequently, there is no one approach that will work for all business owners.

The succession planning process — an overview

In broad terms, the business succession process involves the following stages:

1. Determining whether succession within the family is a viable alternative,
2. Developing your succession plan,
3. Monitoring the implementation of the plan, and making changes as necessary, and
4. Coordinating your succession plan with personal tax planning for retirement and the distribution of your estate.

Each of these steps is equally important. For example, excellent succession plans can be ineffective if they are not properly implemented and sophisticated estate plans can become ineffective if they are not coordinated with a business owner's plan for succession.

Though we've said it before, it can't be stressed enough that succession planning is a process. The success of the process will depend on a number of factors, including: a desire to make it work, healthy family relationships, and trust, honesty and openness among family members. Though matters of family communication are beyond the scope of this bulletin, your BDO advisor can suggest strategies for improving family communication and can offer advice regarding other professionals you might turn to for help in conducting family meetings and setting up a family council.

Is succession a viable alternative?

Determining whether succession to a family member is a viable alternative seems an obvious first step but doing so is not always straightforward. Many business owners do not carefully consider all the issues when deciding whether succession to a family member is a viable alternative.

Business owners often have a plan in their own mind — take the case where one of the children has been active and effective in the business. In such a situation it may seem obvious to you what's going to happen - that child will succeed you. But the goals and objectives of the child may not be in harmony with this plan. Alternatively, some children may be overlooked as a successor because their views and general outlook on business issues differs greatly from that of the founder (due to human nature, we often relate better to people who share the same style and values).

In many cases, problems can arise right at the beginning if you do not deal appropriately with two key questions:

1. Are my children interested in succeeding me?
2. Are my children capable of running the farm when I retire?

To deal with these questions fully, both communication and objectivity are important. When it comes to communication, have you actually asked your child whether he or she wants to succeed you? And if you have, are you sure he or she was truthful in his or her response (knowing how strongly you feel about the farm)? Objectivity in terms of assessing your child's ability to run the business is also important.

Assessing a child's interest in the farm

When assessing a child's interest in any business, it's important to keep in mind that it is often difficult to be objective during this process. You have devoted a great deal of time and resources to developing the farm and, quite naturally, you should be proud of what you have achieved. Chances are your feelings toward the farm are obvious to other members of your family, which creates potential problems for some business owners:

- As a general comment, many business owners may find it difficult to accept that a child does not share his or her interest in the business, and
- A child of a business owner may find it difficult to communicate to the parent that they really are not interested in succeeding them in the business.

For many families, one of the best ways of working through these potential problems is with the help of an outside family business advisor. Family members, especially children of the business owner, may be more willing to share their feelings about the farm, both pro and con, with an independent advisor. The role of an advisor at this stage is to help facilitate information gathering within the family, usually by interviewing family members individually and by then facilitating open discussions between the family members.

Assessing a child's ability

Succession will only work if your business is passed on to a child who has the skill to run it. Where there is one obvious interested candidate, the process is more straightforward — you can focus on evaluating that family member's abilities. Even if you believe the process will be straightforward, it's worth keeping in mind that a family business advisor can be helpful with this task, as the advisor has more experience in assessing strengths and weaknesses of prospective successors, and such advisors bring objectivity to the process. Even if the advisor simply confirms that you have made a wise choice regarding a prospective successor, the advisor may be helpful in setting a development plan to improve the child's skills. Another valuable benefit from involving an advisor is that, depending on your relationship with your child, recommendations made by a third-party often can be more effective or are more warmly received because they do not have emotional strings attached.

Choosing between interested and capable children

The process gets far more complicated and difficult to deal with when more than one child is interested in, and capable of, taking over. The farming business may be limited by the size and profitability of the operation — could your farming business support two or more families? This will need to be analyzed if you are considering the shared leadership options we address below.

In fact, having to choose among possible successors is often one of the main reasons many business owners do not deal effectively with the issue of succession. As parents, we try to treat all children fairly, which usually means treating them as equals. However, when it comes to succession, the reality is you will likely have to pick one child to be your successor.

It is possible to pass on control of your business to various children as partners, but the success rate for this sort of arrangement is generally not as good as you might think, and to pull it off, your children will need a strong sense of trust and harmony as a group. We discuss this issue in more detail in the next section of this bulletin under the heading "Shared leadership". In most cases, however, it is best to choose a single leader, and as just discussed, it may be the only option.

Because many parents can't bear the idea of rating the strengths and weaknesses of their children, this is again a good time to bring in outside help. An advisor can help you make sure your business is passed on to the child best equipped to handle it. Also, an outside business advisor will bring objectivity to the process. As discussed earlier, if one of your children uses a management style similar to your own, it may be difficult for you to be objective when comparing that child to another child with a different management style.

Building objectivity into the process may also help your children deal with the succession process. Though the children who are not chosen may still find the decision difficult to accept, the fact that objectivity was brought to the process should help make the choice easier for all to deal with.

Shared leadership

Earlier, we set forth the reasons why choosing a single leader is usually recommended. There are, however, some structures involving the sharing of control that have been successful for some families. There are two basic approaches that have been known to work:

- Family "partnerships" — Family partnerships can work if each child is a full partner and the partnership agreement specifies that complete consensus is required for all important decisions (note that we are talking about a decision-making arrangement at this point and not necessarily a legal structure). This alternative works in situations where the children see each other as equals and there is a strong desire among the children for succession of the business within the family. If a single leader is chosen and other children in key positions within the business do not accept the choice, the conflict created could destroy both the family and the business.

- First among equals — In an alternative we call "first among equals", one child has more control over most day-to-day decisions, but important, fundamental changes are decided on by the group. In this situation, the boundaries of the leader's responsibilities should be clearly defined and disclosed to all. This option is generally considered where 3 or more children will be involved, and that may not be an option for many farm operations.

The success of both arrangements will depend on shared vision and a strong enough bond among the children that will allow for successful teamwork. The children will need to adopt a balanced approach to building consensus, as very few business partners will agree on everything. As one would expect, the family partnership arrangement is the more difficult of the two to successfully implement.

It should also be noted that the skills required to make these arrangements work don't come naturally to most people. To help smooth the process, the use of a family business advisor as a facilitator can be valuable, particularly in the early stages.

Another approach that some families consider is the idea of rotating control among the children. Though this approach appears to deal with the issue of fairness, it is often a poor business decision. Becoming a leader of a business is a learning process and rotating leadership among a group will more than likely mean the business constantly has a leader in training. In addition, from a customer's point of view, the business can appear to lack clear direction if each successive leader takes the business in new areas.

What happens if you can't identify a successor?

After working through the process of determining whether any of your children have both the desire and capability of succeeding you, you may decide succession within your family just won't work. You could reach this conclusion for a number of reasons, including, for example:

- None of your children are either interested or capable.
- A child has the potential to succeed you, but is not yet ready.
- You have children who are equally interested and capable, but you feel selecting one child over others is not worth the risk of disharmony within your family (or your potential successor may not want to take on the job, given the feelings of the other family members).

Alternatives to passing the business on to a family member

If you conclude that passing the business on to a single family member won't work, take heart (and don't think that there's no point in engaging in business succession planning)! There are two options to consider that may fit the bill:

- ***Sell the farm*** — After all the issues are considered, the best option may be to simply sell the farm and realize the value of the farming assets. Once you have decided that a sale is the best alternative, you and your BDO advisor can make plans about how and when to sell, so that you maximize the value of your business. You can establish an estate plan around the proceeds you will receive from the sale of your business. Remember, passing on a business to new owners is really just another form of business succession.
- ***Divide the farm*** — If you have a large enough farm operation, dividing the farm may be an excellent option, if the smaller separate operations will support each successor's family (especially if the families have a source of off-farm income). One point should be emphasized here – for tax purposes, it is much easier to accomplish such a division while the farm is owned by you (as there is no farm property rollover for transfers between siblings).

Succession plan development and implementation

Once you have decided that family succession makes sense, the next phase is to develop a plan, and begin its implementation. Given that the succession plan should be tailored around the unique characteristics of both your family and your business, every succession plan will be different. Consequently, rather than outlining a specific plan you should use, we'll look at several elements that are common to most successful plans:

- clearly identifying your successor and his or her role,
- transitioning your successor aboard,
- accepting the necessity of a succession plan,
- keeping the succession plan as open as possible,
- establishing a clear timetable for the process,
- developing a clear business plan that extends beyond your retirement,
- seeking outside advice,
- retaining key non-family employees, if any, and
- realization that fairness is not synonymous with equality.

Clearly identifying your successor and his or her role

To be effective, your succession plan should clearly identify who will succeed you and what their role will be. For example, simply transferring your farm to a child and allowing him or her to decide how to run it is not a succession plan and doing so often has a poor chance for success. It will be much easier to effectively transfer control of the farm if family members fully understand their current and future role in running it.

Earlier in the bulletin, we pointed out that most successful succession plans involve the designation of one overall leader. As a general observation, family businesses are successful when compared to larger organizations because of the presence of a strong leader, which often translates into an ability to make important business decisions quickly to capitalize on opportunities as they arise. Consequently, there is a strong bias toward having a clear leader, even though there is potential for disharmony within the family.

Transitioning your successor

Once the successor is named, the goal becomes making sure the successor will be ready to take control when the time comes. There are several ways to meet this goal, including:

- ***Allowing your successor to participate in business decisions*** – In the beginning, you will likely maintain control over major business decisions. However, early on, you should allow your successor to be involved, passing on more responsibility for important decisions as time passes.

- ***Meeting key contacts*** – It will be useful for your successor to see how you manage relationships with important customers, suppliers and other key business contacts. In addition, introducing your successor will also be beneficial to these parties, as it gives them an opportunity to become comfortable with him or her.

- ***Allowing your successor to work in different areas of the business*** – In many cases, the best way to learn about the business is to be directly involved in different areas of it. Be careful, however, to select the work experiences so as to ensure the experience gained is a valuable learning tool.

- ***Gradually allowing your successor to assume your duties*** – Once your successor has a good knowledge of your business and has been involved in decision-making, the next step is to gradually pass on your responsibilities.

Accepting the necessity of a succession plan

Like several other issues discussed in this bulletin, this point seems obvious, but there is more to it than first meets the eye. A succession plan is a plan for change – therefore, for the plan to be successful, a business owner must accept that there will be major changes as the implementation of the plan proceeds. So, for example, the current leader must consciously accept that, over time, the chosen leader will become responsible for more business decisions and may take the business in new directions.

If the current leader keeps a tight rein on decisions made by the successor or exhibits an unwillingness to change, these are sure signs that the founder has not totally embraced the idea of succession. This can create a great deal of frustration for both the founder and the successor and could ultimately cause the successor to move on to other pursuits.

Keeping the succession plan as open as possible

As with any important plan, the succession plan will have a much better chance of being successful if everyone involved has a clear understanding of the plan in general and of each person's role in particular.

The first step in creating an open plan is to ensure the plan is written and is made available to all those directly involved in the succession process. For those not directly involved, communication is still important. The bottom line is the succession plan should be discussed with all who will be affected by it. This means disclosure should go beyond your family — key non-family employees, key customers, suppliers, lenders, and other key business contacts should be aware of your plans.

During discussions with those directly involved, consider going beyond the details of the plan itself. For example, rather than just telling those involved what decisions have been made, it may be useful to explain why certain decisions have been made.

Also, always keep in mind that the way you communicate is important, especially with respect to discussions within the family. Most family business advisors recommend planning meetings specifically to discuss the succession plan and other issues facing the business. This allows family members to focus their attention on the issues facing the business.

Establishing a clear timetable for the process

When developing your plan you should ensure it includes a clear timetable so those involved know exactly what will be expected of them and when. Vague time references should be avoided. For example, if your plan merely states that it is your intention to continue working until the day-to-day responsibilities become too much to handle, your successor will be left uncomfortably waiting for the inevitable — your illness or death. At a minimum, definite dates should be set for the following events:

- retirement of the business owner,
- transfer of ownership, and
- transfer of voting control (if the farm is corporately-owned).

Many business owners will want to retain overall control and ownership until death, though they are comfortable giving up day-to-day control before then. The key is to make sure everyone involved is aware of your intentions and the time frame. Where the farm assets are owned directly by you, it may make sense to incorporate or set up a family farm partnership, so that control and other benefits of ownership can be separated.

One final point to keep in mind is that once you have set a specific timetable you should stick to it. If the timetable is not followed, the credibility of the entire plan will suffer greatly in the eyes of all involved.

Developing a clear business plan that extends beyond your retirement

A clear plan and direction for the business will be of great benefit to your successor. It’s a good idea to develop a business plan that extends beyond your retirement. In addition, involving your successor in the development of the plan will be a valuable learning experience for him or her. Though your successor may take the business in a different direction in the future, a detailed business plan will get him or her off to a good start.

Seeking outside advice

Obtaining outside advice during the succession process is crucial for most business owners, especially for first-generation owners who have not been through the succession process before. Being able to discuss the issues you are facing with others who have been through the succession process is invaluable.

In addition to traditional family business advisors, many family businesses find that reporting to a board of directors or advisors can be very useful, both in the succession process and in business management in general. In the agricultural sector, the use of outside directors is uncommon.

However, it may still be possible to receive outside feedback from peers. For example, some family businesses have made use of personal advisory groups (or PAGs) as opposed to a board of directors — basically organized groups of peers who share their experiences and take on some of the same roles as directors. Outside feedback is useful for several reasons:

- ***Maintain focus on business goals*** — Just the process of preparing reports for the group ***will*** help add focus for those involved.
- ***Identify new ideas*** — Involving outside group members can bring new ideas and insight to the business. In fact, when choosing group members, try to name members who have different skills from your own, or who have knowledge of areas you've identified that could be improved.
- ***Contribute impartial feedback (positive and negative)*** — It is difficult to be objective about any issue when you are involved in the introduction and development of new ideas. Outside group members can bring a fresh outlook to these issues. In addition, they can be used as a sounding board for new ideas.
- ***Add professionalism to the business*** — The process of meeting with a group regularly, reporting to them, and receiving feedback will add professionalism to the business. However, to maintain the professionalism that can be created when choosing prospective group members, it is generally a good idea to exclude close friends.

Retaining key non-family employees

If you have non-family employees who are key to the business, keeping these employees during the succession process will be extremely important. Though the first issue is to ensure that these employees are fairly remunerated, there could be other important issues to deal with as well. It is worth keeping in mind that key employees may feel they are working for you rather than for the business (and this is especially true for farm operations). As a result, it is important they are informed of the succession plan, its progress and its affect on them.

In addition, it is important that key employees have respect for your intended successor. Though this respect will have to be earned over time, it can actually be won or lost before the succession process begins. Consequently, the application of a few simple rules of thumb can pay dividends down the road when the succession process begins:

- ***Encourage your children to work outside of your business before joining*** — In addition to enhancing the credibility of your children in the eyes of non-family employees, there are other benefits as well. For example, the child may develop a higher level of self-confidence and may be in a position to bring new views and ideas to the business.
- ***Avoid premature promotions of family members*** — If it appears to employees that a child has been promoted before his or her time, then both you and the child will lose credibility. In terms of the agricultural sector, this could simply mean that the child is given senior responsibilities too soon even if it doesn't involve a promotion in a strict sense. Even if the child later proves capable, the loss of credibility will be difficult to recover from.
- ***Where possible, try to treat family and non-family employees equally*** — Your employees will obviously realize that family members do enjoy a special status as employees of the business. However, making an effort to treat all employees equitably will benefit you and your successor in the future in terms of things like productivity and loyalty. So, to ensure that employees are treated equitably, it's a good idea to: pay reasonable salaries to all employees based on work performed, carry out performance reviews for both family and non-family employees, and involve both family and non-family members in key decisions, where appropriate.

Realization that fairness is not synonymous with equality

When developing a succession plan, treating your children fairly does not necessarily mean your children should be treated equally. And when it comes to a farm held by larger families, this will be especially true. Earlier we suggested that it is generally a good idea to choose one leader because having the business run by your children as equals often does not work. The concept of fair vs. equal will have a greater impact than usual in the agricultural sector, where there is a stronger bias toward a single successor. In addition, as the successor will often take over the family home along with the farm operation and there will generally be high asset values associated with farm property (primarily land and quotas), there may be few other assets that have a significant value. So, there is the potential for significant disagreement over a farm family in terms of trying to realize the value of the farm assets vs. the continued operation of the farm by one family member.

Where there will be children active in the farm operation and others who will be inactive, one option that can help is an agreement on how the proceeds from the farm will be divided if it is sold. However, the reality is that farms often remain with families for generations, and there is a good chance that the successor will die or transfer the farm to his or her child before the farm is sold.

Due to these issues, there is no better tool than asset diversification — those farm families that can build-up non-farm assets will be ahead of the game in terms of dealing with disharmony within the family when it is time to transfer the farm to the next generation. As we discuss later, one powerful tool for this purpose is life insurance.

Other business planning strategies to consider

In this section, we highlight a few planning strategies that may be useful to you in implementing your succession plan. Even if you are not actively considering succession planning at this time, these strategies may be beneficial to your business. Your BDO advisor would be happy to discuss how these strategies may be useful in your situation.

Shareholder agreements for Family Farm Corporations

If you are transferring ownership of your business, either directly to family members as part of your will or as part of an estate freeze, (which is discussed below), a shareholder agreement is an important tool you should consider. A shareholder agreement is an agreement that governs the conduct of the shareholders and it should address all areas of possible concern. With such a broad mandate, the possible contents of a shareholder agreement are endless.

Each business will have different concerns, and the importance of the issues will vary. But, in general, a shareholder agreement for a family business usually deals with the following key issues in addition to more general business concerns:

Share ownership rules

For many family businesses, the rules that govern who can own shares are the most important part of the shareholder agreement. Specific areas that should be addressed include:

- ***Who will be allowed to hold shares of the business?*** In most cases, ownership will be restricted to family members. For example, many shareholder agreements prohibit in-laws from becoming owners.
- ***What happens in the case of marital breakdown?*** Most provinces provide for family property equalization on marital breakdown. Therefore, where the shares of a family business constitute a large proportion of a couple's property, there is a chance that some shares can become property of the soon to be ex in-law. There are several ways a shareholder agreement can deal with this. For example, the agreement could require that, as a condition of becoming a shareholder, each family member must have a marriage contract that specifically carves out the shares from the category of family property. Or, the agreement can provide that the shares must be immediately offered for sale to the rest of the family on marriage breakdown.

Buy/sell rules

A shareholder agreement should also include rules regarding when and how shares can be transferred. For example:

- ***Can shares be transferred to non-family members?*** There are two basic scenarios that should be addressed: a sale of shares by one family member and a sale of the entire business by all family members. For a sale by an individual family member, the agreement can be restrictive – for example, it could state that all shares must be owned by the family, so only transfers between family members will be allowed. Another option would be to allow for a sale of shares to non-family members, but would require that the shares must be offered to the rest of the family first. For a sale of the entire business, you may also want some special rules. For example, for the approval of such a sale, will a simple majority be sufficient or should a higher threshold be set?

- ***How will the shares be valued?*** As most agreements will allow share transfers at least within the family, the agreement should set out rules for valuing the shares. Note that the valuation method chosen must be reasonable to avoid potential tax problems.
- ***New shareholders must be a party to the agreement*** – Where share transfers are allowed, the agreement should also require that the new shareholder must sign on to the shareholder agreement as a prerequisite for share ownership.

Disability of a shareholder

The agreement should address the procedures to be followed when a shareholder becomes disabled, especially where that shareholder is an employee. In particular, the agreement may provide for disability payments, and perhaps a requirement that the shares be sold to other family members in the case of prolonged disability.

Death of a shareholder

Finally, the agreement should set procedures to follow on the death of a shareholder, including consideration of the following:

- ***Can shares be transferred to the shareholder's heirs on death?*** Depending on the succession plan for the family business, the family may want to restrict who, if anyone, can inherit shares on death. If there is a requirement that the shares must be sold or redeemed, insurance can be used to provide the funds required.
- ***Use of proceeds from corporate-owned life insurance*** — Where the corporation holds the life insurance on the business owner, the shareholder agreement should set out how this insurance is to be used. For example, the insurance proceeds could be used to redeem the deceased's shares or can be paid to other family members to buy shares from the deceased's estate. You'll want to discuss the use of insurance with your BDO advisor.

This is by no means a complete list of issues you should address in a shareholder agreement. The agreement should also provide rules that will help you deal with any other issues you think might arise. By setting out the ground rules in advance in a shareholder agreement, the potential for family conflict will be lessened in the future when these issues arise.

Family Farm Partnership Agreements

Another popular business structure in the agricultural sector is a family farm partnership. Generally speaking, a partnership is a less formal business structure when compared to a corporation. However, we would still suggest that the family have a formal partnership agreement. Such an agreement would discuss issues such as how income should be divided among the partners each year, how assets should be distributed on termination of the partnership (or when the farm assets are sold) and would also deal with many of the same issues that would be contained in a shareholder agreement, which were discussed in the last section.

One of the main advantages of using a partnership is its inherent flexibility. For example, subject to reasonability, if the rules for the division of partnership income are flexible enough, family members can be given a larger share of income over time without the need to amend an existing partnership agreement or entering into a new one. This would effectively allow for a gradual change in ownership. In addition, children can be given a larger interest in partnership property over time by having the child buy into the partnership, or by having the parents sell or gift existing partnership interests. In the case of a corporation, it is often necessary to reorganize the company to make these sorts of changes.

Preserving your assets

Asset preservation is critical for family business owners because most forms of business involve at least some risk. As an owner-manager, there are a number of steps you can take to protect your business assets. For example, a holding company can be useful if your incorporated business generates cash flow in excess of amounts required for business investments and cash paid to you as a salary or dividend. If a holding company holds the shares of your farm corporation, the excess cash can be paid to the holding company as a dividend on a regular basis, and again this cash may be protected from risk in the operating company. The inter-company dividend generally will be tax-free.

Retirement planning and estate planning considerations

Retirement planning and estate planning go hand-in-hand with succession planning – and should be considered at the same time — because all three relate to planning for your future and your family's future. Retirement planning is especially important for business owners because they often pour money earned through the business back into the business rather than taking out enough (in salary, bonuses or dividends) to save for their own retirement. Indeed, the founder's financial needs in retirement are often a critical factor driving other succession plan issues, such as timing of the founder's exit from the business and the structuring of business ownership. Succession will likely fail if funding the founder's retirement puts too great a strain on the business, so retirement planning should start as early as possible.

Estate planning, on the other hand, is usually aimed at maximizing the value of your assets (including the preservation and protection of property during your lifetime) and minimizing and/or deferring tax and other costs arising on your death. As well, estate planning is meant to provide for an orderly transition of assets to your beneficiaries and usually includes providing for your dependants. Once you have set your succession plan you should ensure your estate planning goals are coordinated with this plan.

First we'll look at some general retirement planning issues/ideas and then we'll look at some estate planning techniques that are especially useful for business owners.

Retirement planning

Financial peace of mind is crucial for enjoying retirement. For business owners, there are two distinct ways of engineering this security: creating personal savings by drawing funds over time from the business or "saving within the business", which involves reinvesting cash flow in the business to make it more profitable in the hopes that there will be more in the business to pay out at retirement or the business will provide higher proceeds if sold.

There are advantages and disadvantages to both. Withdrawing money from the business over time allows you to diversify your investments and it offers flexibility, but you will have to pay tax on salary and dividends withdrawn from an incorporated business and draining cash from the company may be financially dangerous to the company. Saving by building up the value of the farm may be advantageous where the business returns are higher than portfolio returns you might earn, but this technique carries higher risk, since any business is generally riskier, and risk management is not always possible. Another factor will be the ability of your children to pay you if they take over the farm — the farm may have a high asset value, but provide insufficient cash flow to both support the child's family and to fund your retirement.

There is no right or wrong answer to the question of how best to provide for your retirement — you will have to decide what you are most comfortable with and what makes most sense in your situation. But the important thing to remember is that as the owner of a business, you do have flexibility when it comes to creating a source of income in retirement, and you should consider each of these retirement savings options when planning for retirement.

Whether you are a proprietor, partner or owner of a corporation, an RRSP is a key retirement planning tool. If you have earned income, you can contribute 18% of your previous year's earned income up to a maximum amount for the current year, less your pension adjustment (PA) for the previous year (if you are a member of a pension plan). For 2017 the maximum contribution amount is $26,010, less your PA for the prior year. This limit will be increased to $26,230 in 2018. If you are a proprietor or partner, your share of farm income is earned income. For those who have incorporated their business, salary received from the corporation (but not dividends) will be earned income for RRSP purposes.

If you operate a family farm partnership, you can remain in the partnership and receive a reasonable share of income each year. Similarly, where you have incorporated, and you remain a shareholder in retirement, the corporation can pay dividends to you.

In addition to these retirement options, there are other specific options available to those who have incorporated their farm business:

- ***Pay yourself a retiring allowance*** — You can make an additional contribution to your RRSP on retirement by having your corporation pay you a reasonable retiring allowance (which the company can deduct). Provided that you worked actively in the business before 1996 as an employee of a corporation, a retiring allowance paid to you can be transferred to your RRSP, up to the following limits:
  - $2,000 for each year of service before 1996, plus
  - $1,500 for each year of service before 1989, provided that you were not a member of a company-run pension plan.
- ***Use an Individual Pension Plan*** — It may be possible to set up a pension plan for yourself, and other family members, known as an individual pension plan or IPP. For older business owners, the potential retirement benefits provided by an IPP may exceed the benefits provided by regular RRSP contributions. The rules are complicated, however and these plans are more costly to run when compared to a conventional RRSP. In addition, there have been recent legislative changes that will change the benefit that an IPP may have over other plans and this has left many experts wondering whether IPPs are still an advantageous way of saving for retirement. Talk to your BDO advisor to see if IPPs may make sense for you. An important note – an IPP is not available to farm owners who are proprietors or partners, as it is generally not possible to pay yourself a salary. Incorporation is usually required to establish an employment relationship.
- ***Receive dividends in retirement*** — If you hold shares of a corporation, dividends can be paid on the shares as a source of income. Alternatively, your shares could also be redeemed over time, which can also provide for a source of income (the value of the shares in excess of their paid-up value is deemed to be a dividend).
- ***Use a holding company*** — As businesses grow in size, it is common to have multiple shareholders. Where the cash flow needs of shareholders vary, a holding company can be useful as a retirement savings vehicle. For example, if you receive dividends that you don't need for current cash needs, it may make sense to hold some shares through a holding company, as it may be possible for that company to receive dividends on a tax-free basis. As discussed earlier, such a plan also protects excess cash from business risk.

Finally, another source of retirement funds is the sale of the farm to your children (assuming of course they will have enough cash flow to pay for the business over time).

As we said, given that there is risk associated with all businesses, it is usually prudent to use some or all of the methods discussed to save for retirement. Remember, if the business should fail or experience cash flow problems, it is important for you to have other sources of income to fall back on. Another advantage of diversification is the ability to treat your children fairly, where some children will be involved in the farm operations and others won't – non-farm assets can be bequeathed to the inactive children on your death.

Estate planning techniques

As previously mentioned, once you have set your succession plan, you should then ensure that your estate planning goals are coordinated with this plan. When coordinating the estate and succession planning, balance is critical. There are many tools you can use to maximize your estate, but you also need to ensure that the steps you take do not have a negative effect on your succession plan. In the rest of this section, we discuss estate planning considerations within the framework of a succession plan.

In many respects, family business owners face the same estate planning issues as individuals in general. Consequently, all of the issues discussed in our Estate Planning tax bulletin may apply to an owner of a business (a copy can be obtained from your BDO advisor, or from our website at bdo.ca). However, as the investment in the business is usually the most significant asset held by most family business owners, there are a number of important estate planning issues they need to address.

Where farm property will be transferred to your children, you have one major advantage that is not available to other business owners — a tax rollover for intergenerational transfers of farm property. If the farm property is transferred as an inheritance on death or is sold for proceeds during your lifetime that don't exceed the tax cost of the property, the accrued gain on farm property will be transferred to your children. This is a powerful succession planning tool. Assets qualifying for this rollover include assets used directly in the farm business such as land, buildings machinery and quota. In addition, investments in a family farm partnership or family farm corporation also qualify (specific conditions must be met).

Note that the estate planning techniques referred to in this bulletin are discussed based on Canadian tax principles. If you are a U.S. citizen or resident, there may be adverse U.S. tax consequences to proceeding with such an estate freeze. A U.S. tax specialist should be consulted early in the estate planning process to help to minimize the total taxes.

Freezing the value of your estate

As discussed above, a rollover is available on farm property, so an estate freeze on qualifying farm property is not necessary when looking strictly at tax planning. That said, an estate freeze is a still a useful tool for non-farm property that has an accrued gain. In addition, an estate freeze may also provide advantages from a non-tax perspective as part of the succession process. We'll discuss the non-tax benefits later in this section.

Where a tax rollover isn't available, at the time of death you will be subject to tax on accrued gains on your assets, as you will be deemed to dispose of the assets at fair market value.

Defer tax with an estate freeze

Though it is difficult to reduce the tax payable on gains on non-farm property (being property that does not qualify for the intergenerational rollover we just discussed) that have already accrued, there is a common technique, called an "estate freeze," that you can use to limit your capital gains in the future. By freezing the value of your non-farm investments, future gains will accrue to shares held by your heirs and the gain won't be taxed until they sell their shares (or have a deemed disposition on death).

In addition to ensuring tax on future gains will be deferred, an estate freeze will allow you to effectively lock-in the tax liability that will arise on your death (subject to changes in tax rates in the future). By locking in the tax liability, you can plan ahead to fund this tax liability.

How does an estate freeze work?

There are many ways to accomplish an estate freeze. One common method is to transfer the assets you wish to freeze to a holding company in exchange for fixed value preferred shares of that corporation. This transfer can be accomplished on a tax-deferred basis using tax rollover rules.

Your heirs (or a trust for their benefit) can then subscribe for the new growth shares (generally common shares) of the operating company. At the time of the estate freeze, the value of these common shares would be nominal, but as the value of the business grows, this growth will accrue to the new common shares held by your family or a trust.

In many cases, the property owner will actually take back two classes of shares on an estate freeze — the preferred shares we just described, plus a special class of non-participating voting shares. By holding these shares, you can retain control over the corporation, provided the special voting shares carry more votes than the new common shares. This will be especially important if you intend to have your preferred shares redeemed over time.

You can also freeze your estate by using a trust. Under this alternative, you can transfer the assets you wish to freeze to a trust whose beneficiaries would be your intended heirs. This allows future growth to accrue to your beneficiaries without giving them control over your assets.

The major difference between using a trust and a corporation for an estate freeze is that it is generally not possible to transfer property to the trust on a tax deferred basis. Consequently, tax may have to be paid on any accrued gains on the assets at the time of the transfer. For this reason, this form of an estate freeze is not common for an owner of an established family business. However, if accrued gains are small or the gain arising from the transfer can be offset with a capital gains exemption claim, freezing with a trust can be advantageous, as assets held in the trust will not be subject to the deemed disposition rules that apply on death. It should be noted, however, that for tax purposes assets held by a trust are subject to a deemed disposition at fair market value every 21 years.

When to freeze?

To maximize your deferral, an estate freeze should be carried out as soon as possible, as this will limit the accrued gain on your shares and ensure that future growth accrues for the benefit of your children. However, before you freeze, there are two important issues you need to address:

1. If you freeze the value of your shares now, will this leave enough value for you to live on in the future?
2. Has the timing of your estate freeze been properly coordinated with your retirement and succession plan where the property subject to the estate freeze will be passed along with the farm to the successor?

When dealing with the first question there is an important point to keep in mind. Though it may be possible to undo (or "thaw") an estate freeze, it is generally a good idea to assume you might not be able to access the future growth of the property to support yourself.

Coordination with your retirement and succession plan

For an effective estate freeze, your children have to own common shares. Consequently, you'll need to consider this when planning for an estate freeze. If you are reluctant to turn over full ownership of common shares to your children, a family trust is generally used to hold the new growth shares until you are ready to turn over ownership to the children. If the trust is discretionary, the division of the common shares among your children can be deferred. However, even with this flexibility, the timing of your estate freeze is still important.

Family trusts are a powerful planning tool, but they also have limitations. One important limitation is the 21-year deemed disposition rule. Under the tax rules for family trusts, your trust will have a deemed disposition every 21 years. Therefore, if the trust still holds the shares 21 years after the estate freeze, the trust may be subject to tax on a capital gain equal to the gain that has accrued over the 21 years. Consequently, when timing an estate freeze, you will need to be ready to turn over ownership of the shares held by the trust within 21 years.

Using an Estate Freeze for Farm Succession

Strictly speaking, an estate freeze is not needed from a tax perspective, as farm property can be transferred to your children at its tax cost. However, based on our experience, you may want to consider an estate freeze for non-tax reasons — it can be used to divide the accrued gain from your efforts in the past from the accrued gain that will arise in the future from the efforts of your successor(s). This can have a positive effect, as they will have a sense of ownership and the future growth from their efforts will accrue to the common shares that they hold.

Using insurance

Life insurance is a powerful tool when used alongside an estate freeze as the proceeds will become available at the same time tax arises on assets with accrued gains that are not eligible for the farm property rollover. Once you freeze your estate, you can purchase enough insurance to pay the projected tax liability on the assets frozen.

Life insurance has a second important use in estate planning for family business owners, and for farm business owners in particular. As discussed earlier, we suggested that treating your family fairly doesn't necessarily (and often does not) mean treating them equally when it comes to your business. In particular, splitting the farm property among active and inactive children can cause problems. To avoid these problems and still be fair, insurance can create an “instant estate” that can be used to provide for children who are not active in the business.

There are several ways insurance can be used for this purpose. For example, the insurance proceeds can simply be paid as an inheritance to children who are not active in the business. Or you can bequest shares of a family farm corporation to all of your children and the insurance proceeds can be made payable to the corporation, which will use the proceeds to redeem shares held by non-active family members. The best plan for you will depend on several factors, such as the relative number of active and inactive children and the value of the business compared to the value of the estate as a whole.

Summary

We have discussed many issues in this bulletin. In planning your future and the future of your farm, the decisions you need to make may seem overwhelming. It is important to keep in mind that succession and estate planning are not events, but processes. As such, these issues are best dealt with over time with the help of your BDO advisor.